

Internal Revenue Service  
**memorandum**

CC:TL-N-4970-87

Brl:HFRogers

date: APR 24 1987

to: District Counsel, Washington, D.C. CC:WAS

from: Director, Tax Litigation Division CC:TL

subject:

Dkt. No. [REDACTED]

ISSUE

Whether to pay the \$ [REDACTED] filing fee requested by the petitioners in light of the recent Tax Court decisions in Phillips v. Commissioner, 88 T.C. No. 26 and Minahan v. Commissioner, 88 T.C. No. 23. RIRA No. 7430.00-00.

CONCLUSION

We concur in your settlement proposal. Given the facts in the instant case, this case represents a poor litigating vehicle to advance this I.R.C. § 7430 argument.

FACTS

On November 21, 1986 you requested technical advice concerning the payment of a \$ [REDACTED] filing fee which the petitioners, the [REDACTED], had requested. On February 20, 1987, we responded and concurred with your position that it should not be paid.

This position was based on two grounds. First, the District Counsel had not reviewed the statutory notice of deficiency and was not involved in the case at the administrative level, so there was no prelitigation position subject to scrutiny under the "not substantially justified" test of section 7430(c)(2)(A)(i). Further, given the facts in the instant case, the court could find that the Service's post-petition position

08332

was justified. Secondly, the petitioners responded to the 30-day letter by sending an explanatory letter to the Service Center, and did not request an Appeals office conference, so they did not exhaust their administrative remedies and did not satisfy section 7430(b)(1).

There has been no change in the facts as stated in the February 20, 1987 Technical Advice.

### DISCUSSION

Section 7430 authorizes the award of reasonable litigation costs to taxpayers in certain circumstances. Under section 7430, in order to be entitled to an award of litigation costs, the taxpayer must:

- (1) substantially prevail in the litigation (section 7430(c)(2)(A)(ii));
- (2) establish that respondent's position is not substantially justified (section 7430(c)(2)(A)(i)); and
- (3) have exhausted the administrative remedies available to that taxpayer in the Internal Revenue Service (section 7430(b)(2)).

See Minahan v. Commissioner, 88 T.C. No. 23 (1987).

#### 1. Substantially Prevail

In the instant case, the taxpayers have substantially prevailed. Prevailing as to the most significant issue and prevailing as to the amount in controversy are alternative grounds for concluding the taxpayer has substantially prevailed. See Phillips v. Commissioner, 88 T.C. No. 26 (1987). After contacting the utility company which had incorrectly reported the amount of dividend income to the Service, the Appeals office sent the taxpayers a decision document indicating a zero deficiency on the only open issue-the proper amount of dividend income the taxpayers should have reported. The taxpayers prevailed as to both the issue and the amount so they have satisfied the requirements of section 7430(c)(2)(A)(ii).

#### 2. Substantial Justification

Both Minahan, supra, and Phillips, supra, dealt with cases that had been instituted prior to the changes in section 7430 that were enacted by the Tax Reform Act of 1986. There has been

no change in the position of our office as stated in "Section 7430(c)(4): 'Position of the United States'" in the February 20, 1987 Technical Advice. Our position then was that upon a review of the ~~facts~~ the Service's litigating position was substantially justified. And, that the issuance of the notice of deficiency and the underlying administrative action in this case did not constitute a "position of the United States" and were not subject to scrutiny under the "not substantially justified" standard since the District Counsel had not yet taken any action or inaction.

Although our position remains the same, in light of the present judicial climate, especially as articulated in Phillips, supra, we concur in your decision to settle.

In Phillips, the court found the taxpayer owed no deficiencies or additions to tax. To reach this holding, the court had to overrule an earlier Tax Court case, Durovic v. Commissioner, 54 T.C. 1364 (1970), aff'd, 487 F.2d 36 (7th Cir. 1973), which the Service was relying on in the Phillips case. The court found the Service was unreasonable in not following two revenue rulings which were inconsistent with the holding in Durovic. (Before the changes in section 7430 as enacted by the Tax Reform Act of 1986, the second prong of the test was that the taxpayer must establish that respondent's position was unreasonable). Therefore, the Tax Court found the Phillips had established the position of the United States was unreasonable because it was arbitrary, and the second prong of the section 7430 test was met.

In Minahan, on the other hand, the Tax Court found respondent was unreasonable because he relied on a revenue ruling with which a number of cases were inconsistent. The court in Minahan found respondent's persistence in following a revenue ruling which was inconsistent with case law to be unreasonable. (Again the court looked at a standard of unreasonableness, not the current "not substantially justified" standard.)

In the instant case, we have a case of first impression as to whether the Tax Court will concur with our analysis of the new statutory language of section 7430(c)(4)(B). As we analyze the pertinent language, the first relevant prelitigation action or inaction is that taken by the District Counsel. Looking at how the court in Phillips stretched to find that the government was unreasonable because the Service relied on the frequently cited case of Durovic, rather than on their own revenue rulings, the ~~facts~~ that we are relying on in this case to uphold our litigating position are substantially weakened. It will take a

much lesser stretch for the court in the instant case to determine that all prelitigation action taken by the Service can be examined for reasonableness. The taxpayers had supplied all the information requested by the Service in a timely manner, so the court could find it was unreasonable for the Service not to verify this information before sending the taxpayers a statutory notice of deficiency. See Rosenbaum v. Commissioner, 615 F. Supp. 23 (N.D. Ohio 1985) (position prior to litigation unreasonable-Service should have investigated the information supplied by the taxpayer prior to imposing a levy). The court could also review our litigating position and conclude the Service should have determined the correct dividend amount in less than the five months it took between the filing of the petition and the mailing of the decision document. This is a factual determination, but the courts look at the difficulty of the issue presented. This was not a difficult issue, it required only a phone call to straighten the problem out.

Based on the foregoing analysis, we agree that, although our position remains the same regarding the correct interpretation of the new section 7430(c)(4) language, this case is not the proper vehicle to use to litigate this position.

### 3. Exhaustion of Administrative Remedies

The Tax Courts in both Minahan, supra, and Phillips, supra, analyzed whether the petitioner had exhausted his administrative remedies. In both cases, the court's position was more liberal in finding the taxpayer had exhausted such remedies than was our position in the February 1987 Technical Advice.

Our position on this issue, as stated in the February 20, 1987 Technical Advice, is that: "In a case such as this, a taxpayer will not have exhausted its administrative remedies, unless, prior to the issuance of a notice of deficiency, it requests an Appeals conference, and agrees to extend the time for assessment of tax if necessary to provide the Appeals office with reasonable time to consider the matter. Treas. Reg. §§ 301.7430-1(b)(ii); 301.7430-1(g), ex. 12."

In that Technical Advice, we agreed with your conclusion that petitioners herein have not exhausted their administrative remedies. Petitioners chose the first option provided for in the 30-day letter, they submitted a written explanation of why the alleged understatement of dividend income was incorrect. Petitioners did not select the third option - an Appeals conference. The Service's position is that having failed to request an Appeals conference as required by the regulations, petitioners have not exhausted their administrative remedies under section 7430(b)(1) and therefore are not entitled to an award of litigation costs.

The analysis above is still a correct statement of our position. However, in light of the holdings of the Tax Courts in Minahan, supra, and Phillips, supra, we are not opposing your decision to settle the \$ [REDACTED] filing fee issue based on the facts in the instant case. See Conclusion, infra.

In Phillips, the court found the petitioner had exhausted his administrative remedies because the sole issue for decision was whether the petitioner could file a joint return, and that issue arose after the notice of deficiency was mailed. Therefore, the taxpayer was not aware of this issue until after the petition was filed, and his failure to perform an Appeals office conference under the circumstances was not fatal. The court concluded the petitioner did not turn his back on any opportunity afforded him for negotiation of the issue. The court found the petitioner satisfied the requirements of section 7430(b)(2).

In the instant case, on [REDACTED] the taxpayers sent the Service all relevant documents on which they relied which satisfied the first option in the 30-day letter. Rather than conducting an investigation or asking the taxpayers to come in for a conference the Service issued a statutory notice of deficiency two months later. After the taxpayers filed their petition in court, the utility company was contacted by an Appeals officer and substantiated the amount the taxpayer had reported. Then the Service concurred. Under these facts, the court could conclude the taxpayers took advantage of all administrative remedies offered to them.

In Minahan, the Service had begun an audit to determine if stock purchase agreements reflected fair market values. The petitioners refused to extend the statute of limitations on the assessment, so shortly before the expiration of the statute of limitations, the Service determined deficiencies in petitioner's Federal gift taxes. Later, the Service conceded all disputed issues.

The Service's position in Minahan was that the petitioners failed to exhaust their administrative remedies because: (1) they failed to participate in an Appeals office conference and (2) they refused to extend the time for assessment of tax. The second point is not important in the present query. Addressing the first point, the court found the controlling statute focuses on "the administrative remedies available to such party within the Internal Revenue Service." 88 T.C. No. 23 at 18.

In Minahan, the Service did not issue preliminary notices of proposed deficiency (30-day letters) because the period of assessment was due to expire and petitioners refused to extend this period. Instead, respondent issued notices of deficiency on the last day they could before the expiration of the statute of limitations. Petitioners then filed their petition in court, before participating in an Appeals office conference. The court held since respondent did not make an Appeals office conference available to petitioners, the Appeals office conference was not an administrative remedy available to these petitioners, and it was not an administrative remedy which petitioners failed to exhaust.

The Tax Court in Minahan noted that it did not disturb the provisions in the regulations that require a taxpayer to participate in an Appeals office conference if that administrative remedy is made available to that taxpayer within the Internal Revenue Service. And the court concluded that requests for information at the audit level may be viewed as administrative remedies because they may result in the parties reaching informed agreements which avoid the necessity of litigation.

In the present case, the Service provided the taxpayers with a choice of three options, one of which was the Appeals office conference. The taxpayers chose a different option - mailed a letter to the Service explaining the discrepancy and attached a letter from the utility company verifying the amount of dividends which the taxpayers received. They also left a phone number where they could be contacted after 6:00 p.m. No one contacted the utility company or the taxpayers until after the statutory notice of deficiency was mailed and the taxpayers filed a petition in court. Subsequent to the petition being filed, an Appeals officer contacted the utility company and verified that the taxpayers had correctly reported their income. Then a decision document was mailed to the taxpayers indicating a zero deficiency.

In this case, the court may conclude the taxpayer took advantage of the administrative remedy available to them. They selected one of three options which the Service proffered to them. They supplied all relevant information in a timely manner which would have enabled the Service to reach an informed agreement. Under Minahan, a court could find petitioners exhausted their administrative remedies.

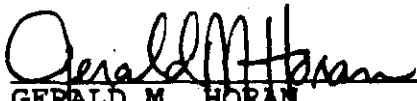
CONCLUSION

We still adhere to our positions articulated in the original Macaluso Technical Advice. Further, we agree with your analysis that the instant case does not present the strongest facts with which to advance our position. Also, since this is an "S" case under section 7463, this case cannot be cited as a precedent in any other case. Therefore even if you expended the time and effort necessary to advance our contention, if the Tax Court agreed with our position it would not help us in any later cases. Accordingly, we concur in your decision to settle this issue and pay the \$[REDACTED] litigation costs incurred by these taxpayers.

If you have any further questions, please contact Helen F. Rogers of this office at 566-4189.

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